

Internal Revenue Service
memorandum

CC:INTL-701-90
Br2:JKSams

date:

to: Bill Perkins, International Examiner, Dallas District Office

from: Jim Sams, Attorney, Branch 2, Office of Associate Chief Counsel
(International) CC:INTL:Br2

subject: THIS DOCUMENT CONTAINS PRIVILEGED INFORMATION UNDER SECTION 6103 OF THE INTERNAL REVENUE CODE, AND INCLUDES STATEMENTS SUBJECT TO THE ATTORNEY-CLIENT PRIVILEGE AND THE ATTORNEY WORK PRODUCT PRIVILEGE. THIS DOCUMENT SHOULD NOT BE DISCLOSED TO ANYONE OUTSIDE THE IRS, INCLUDING THE TAXPAYER(S) INVOLVED, AND ITS USE WITHIN THE IRS SHOULD BE LIMITED TO THOSE WITH A NEED TO REVIEW THE DOCUMENT FOR USE IN THEIR OWN CASES.

Following our telephone discussion in November, you submitted a brief statement of facts, accompanied by supporting documentation, raising the issue of whether income of a controlled foreign corporation from the sale of stocks and securities was excluded from foreign personal holding company income pursuant to section 954(c)(3)(B) of the Code. We discussed these issues in telephone conversations in December and January, and you have asked that we send you informal technical assistance documenting the issues we discussed.

The facts are represented as follows. [REDACTED] was organized as a wholly owned subsidiary of [REDACTED] in [REDACTED]. [REDACTED] in turn is a wholly owned subsidiary of [REDACTED], a domestic corporation. Both [REDACTED] and [REDACTED] are Swiss companies. In addition, you have stated that [REDACTED] operates under the jurisdiction or with the approval of Swiss banking authorities. The taxable years at issue end in [REDACTED] of [REDACTED], [REDACTED] and [REDACTED].¹

For its taxable year [REDACTED]'s balance sheets reflect total assets of approximately \$ [REDACTED], which include \$ [REDACTED] in loans and advances and \$ [REDACTED] in investment securities. [REDACTED]'s liabilities for that year include stockholder equity of \$ [REDACTED], retained earnings of \$ [REDACTED], and amounts due to banks of \$ [REDACTED]. The figures for its taxable year [REDACTED], for which total assets are \$ [REDACTED], reflect loans and

¹ Because the taxable years at issue begin before the effective date of the applicable provisions of the Tax Reform Act of 1986, Pub. L. No. 99-514, all section references are to the Internal Revenue Code of 1954.

008125

advances of \$[REDACTED] and investments in securities of \$[REDACTED] on the asset side, and amounts due to banks of \$[REDACTED] and retained earnings of \$[REDACTED] on the liabilities side. With one exception, the loans described in the financial statements covered periods of six months or less. One loan covered a term of [REDACTED] months. In many cases, the amount and duration of a loan made by [REDACTED] is matched by the amount and duration of a borrowing from an unrelated entity.

The total number of loans and advances made by [REDACTED] during its taxable year [REDACTED] is not clear, because the financial statements provided do not cover all periods of the taxable year. Moreover, certain entities are identified as having received more than one loan from [REDACTED]. All of [REDACTED]'s loans and advances appear to have been made to unrelated parties.

In general, a U.S. shareholder of a controlled foreign corporation is required to include currently in its gross income its share of the subpart F income of the controlled foreign corporation, described in sections 951 through 964 of the Code. Foreign personal holding company income, a category of foreign base company income (which in turn is a category of subpart F income) described in section 954, includes interest, dividends, and gains from the sale of stocks or securities. See section 954(c). Pursuant to section 954(c)(3)(B), however, foreign personal holding company income does not include dividends, interest and gains from the sale of stocks or securities derived in the conduct of a banking, financing or similar business, if such income or gains are received from unrelated persons. This exception was provided in part to address the concern that such income of a corporation engaged in banking activities generally would not arise from passive investments; for example, income from stocks and securities acquired as a result of a foreclosure. See H.R. Rept. No. 1447, 87th Cong., 2d Sess. __ (1962), 1962-3 C.B. 446. Thus, a corporation's income from stocks and securities will qualify for the exclusion from treatment as foreign personal holding company income only if two tests are satisfied: first, the corporation must be engaged in the conduct of a banking, financing or similar business; and second, the corporation must hold the stocks and securities in the ordinary course of such business.

1. Is [REDACTED] engaged in the conduct of a banking business?

A controlled foreign corporation is engaged in the conduct of a banking business within the meaning of section 954(c)(3)(B) of the Code if it engages in any of the activities described in section 1.954A-2(d)(2)(ii), which include the following: receiving deposits of money from the public; making personal, mortgage, industrial, or other loans to the public; and,

████████████████████ purchasing, selling, discounting, or negotiating for the public on a regular basis, notes, drafts, checks, bills of exchange, acceptances, or other evidences of indebtedness. Other financial activities are also described. Interest and dividend income from, and gains from the sale of, stocks or securities are excluded from foreign personal holding company income to the extent that such income or gains are derived from securities or stock acquired and retained as an ordinary and necessary incident to the conduct of a banking, financing or similar business. Section 1.954A-2(d)(2)(iii). For example, gains from the sale of stock acquired as a result of a foreclosure on a loan made in the ordinary course of a banking business are considered to be gains derived as an ordinary and necessary incident to the conduct of a banking business. Id.

████████████████████ is a U.S. shareholder of ██████████, a controlled foreign corporation, within the meaning of subpart F of the Code. See sections 957, 958. ██████████ argues, however, that its dividend and interest income from, and its gains from the sale of, stocks and securities were derived in the conduct of a banking business within the meaning of section 954(c)(3)(B), and that therefore such income of ██████████ is not foreign personal holding company income for purposes of subpart F.

██████████ did engage in one of the enumerated activities of a banking, financial or similar business described in section 1.954A-2(d)(2)(ii) of the regulations; namely, making loans to the public. An argument may be made that the loans identified on the financial statements of ██████████ are not in sufficient number to constitute engaging in a banking business for purposes of section 954 of the Code, since the total number of loans made to unrelated parties is not clear.² ██████████ appears to have made a greater number of loans than were made in cases considered in our published rulings, however. Compare Rev. Rul. 82-209, 1982-2 C.B. 157. Accordingly, we do not recommend challenging the issue of whether ██████████ is engaged in a banking, financing or similar activity within the meaning of section 954(c)(3)(B) of the Code.

2. Were securities held in the ordinary course of business?

If ██████████ is considered to be engaged in a banking, financing or similar business within the meaning of section 954(c)(3)(B) of

² We would argue that loans made to a single entity within the same taxable year at essentially similar terms, as is the case with certain loans made by ██████████, should be treated as a single loan in determining whether a corporation is engaged in a banking business for purposes of section 954(c)(3)(B) of the Code.

the Code, its dividends and interest income from, and its gains from the sale of, stocks and securities will be excluded from treatment as foreign personal holding company income only if it is determined that the stocks and securities were held by [REDACTED] in the ordinary course of its banking business.

We believe that [REDACTED]'s income derived from its stocks and securities fails to satisfy this test, since there is no evidence to support a determination that the stocks or securities were acquired and held as an ordinary and necessary incident to the conduct of a banking business. See section 1.954A-2(d)(2)(iii) of the regulations. No evidence is provided demonstrating that [REDACTED] acquired the stocks or securities as collateral on a loan, as payment of a loan, or as a result of foreclosure. Further, no evidence is provided demonstrating that [REDACTED] is a dealer in stocks and securities and that the stocks and securities were held by [REDACTED] for sale to customers as part of its trade or business. [REDACTED]'s investment in stocks and securities appears instead to have been conducted independent of its loan activity.

In addition, [REDACTED]'s balance sheets indicate that several of its loans were matched in amount and duration by borrowings from unrelated entities. For example, in identifying its loans and advances as of [REDACTED], [REDACTED]'s balance sheets reflect a loan to [REDACTED] of [REDACTED] for [REDACTED] to [REDACTED], and a loan to [REDACTED] of \$ [REDACTED] for [REDACTED] to [REDACTED]. [REDACTED]'s balance sheets for the same period identify a borrowing from [REDACTED] of [REDACTED] for [REDACTED] to [REDACTED], and a borrowing from [REDACTED] of \$ [REDACTED] from [REDACTED] to [REDACTED]. Absent evidence to the contrary, it may thus be inferred that [REDACTED]'s investment in stocks and securities was financed largely by its substantial capital, further supporting a determination that [REDACTED]'s investment in stocks and securities was made independent of any banking, financing or similar business.

Accordingly, based on the foregoing, [REDACTED]'s income from stocks and securities is not income incident to the conduct of a banking, financing or similar business, but instead must be characterized as foreign personal holding company income. We are assuming, moreover, that [REDACTED]'s gains from stocks and securities are derived from sales to unrelated parties, since gains from the sale of stocks or securities to related parties do not qualify for the exclusion from foreign personal holding company income under section 954(c)(3)(B) under any circumstances. See section 1.954A-2(d)(2)(i) of the regulations.

If you have any further questions or comments, please call me at FTS 566-6645.